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D. Craig Martin

SCIENTER'S SCOPE AND APPLICATION IN RULE 10b-5 ACTIONS: AN ANALYSIS IN LIGHT OF *HOCHFELDER*

I. Introduction

Rule 10b-5 was issued in 1942 under the authority granted the Securities and Exchange Commission (SEC) by § 10(b) of the 1934 Securities Exchange Act. That statute, enacted in the wake of the 1929 Crash, was designed to eliminate improprieties in the securities market, which common law and then existing statutory remedies were deemed inadequate to curtail.[1]

Upon a cursory reading, the purpose of § 10(b) appears evident; nonetheless, its enforcement and legal clout has been uncertain. Since its inception, a semantic debate has ensued as to the precise meaning to be given the statutory language. In pertinent part it provides that:

> It shall be unlawful for any person directly or indirectly . . . to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[2]

Some courts and commentators contend this must be read strictly so as to proscribe only traditionally fraudulent conduct, *i.e.,* conduct in which actual knowledge or intent is present, or can be imputed, because of defendant's recklessness.[3] Conversely, others argue that its scope must be liberally defined so as to effectuate the Act's broad remedial purpose, and thus extend to proscribe negligent behavior.[4]

The SEC promulgated Rule 10b-5, which reads in part:

> It shall be unlawful for any person, directly or indirectly . . . (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any persons in connection with the purchase or sale of any security.[5]

The effect of this regulation was to extend liability under § 10(b) to purchasers as well as sellers. Apparently, the rule was not intended to provide a cause of action for private litigants.[6] The Commission's intent was to provide a rule

1 For a discussion of the inadequacy of pre-Rule 10b-5, common law remedies and federal securities laws, *see* A. JACOBS, THE IMPACT OF RULE 10b-5, §§ 2,3 (1976). 1976).

2 Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970).

3 *See* notes 59-78 *infra* and accompanying text.

4 *See* notes 52-58 *infra* and accompanying text.

5 17 C.F.R. § 240.10b-5 (1976).

6 Milton Freeman, a SEC attorney at the time of the Rule's promulgation stated that the Rule "was intended to give the Commission power to deal with this problem [fraudulent purchases]. It had no relation in the Commission's contemplation to private proceedings." *Conference on Codification of the Federal Securities Laws,* 22 BUS. LAW. 793, 922 (1967).

under which its enforcement powers would be expanded.[7] However, no standards of conduct which would be regarded as violative of the Rule were provided. Accordingly, the Commission's efforts failed to resolve the interpretive problems occasioned by § 10(b).

This absence of articulate standards for liability under the Rule has given rise to frequent litigation over the past three decades resulting in inconsistent determinations of the elements constituting a cause of action. In fashioning standards of liability under Rule 10b-5, the interpretive problems encountered by the courts have been compounded by the numerous forms of relief, based on varying standards, which have been sought under the Rule.[8]

The Securities Exchange Act of 1934 authorizes the SEC to enjoin violations of the Act,[9] but does not provide an express right to damages in a private action under § 10(b). Nevertheless, federal courts have implied a private right of action from the statute and Rule 10b-5.[10] (The courts have uniformly applied a negligence standard for SEC injunctive actions.[11]) However, recovery in actions for damages brought by private parties has been dependent upon court construction of § 10(b) and the Rule with regard to the requisite mental state component; some courts require an element of intent, others mere negligence. Thus, the existence of a private cause of action for damages under Rule 10b-5 has often been a function of the court in which the suit was brought.

To establish uniformity with regard to this issue, the Supreme Court, in *Ernst & Ernst v. Hochfelder,*[12] held that a private cause of action for damages will not lie under § 10(b) or Rule 10b-5 unless scienter is alleged. Scienter, as defined by the Court, is the "intent to deceive, manipulate or defraud."[13] In establishing this standard for the mental state component of a 10b-5 violation, the Court reversed a rapidly developing trend in favor of a mere allegation of negligence.[14] Although an attempt was thus made to settle an issue which had been the subject of frequent litigation, the Court's decision has raised other issues which will undoubtedly arise in future 10b-5 suits.

In a footnote, the Court stated:

> In this opinion the term 'scienter' refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.
>
> Since this case concerns an action for damages we also need not consider the question whether scienter is a necessary element in an action for injunctive relief under § 10(b) and Rule 10b-5.[15]

7 *Id.*
8 *See generally,* 3 A. BROMBERG, SECURITIES LAW: FRAUD §§ 9,10 (1975).
9 *See* note 88 *infra.*
10 A private cause of action under Rule 10b-5 was first implied in Kardon v. National. Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).
11 *See* note 97 *infra.*
12 96 S. Ct. 1375 (1976), *rev'g* 503 F.2d 1110 (7th Cir. 1974).
13 *Id.* at 1381.
14 *See, e.g.,* Devnir, *Rule 10b-5 Damages; The Runaway Development of a Common Law Remedy,* 28 U. FLA. L. REV. 76 (1975).
15 96 S. Ct. at 1381 n.12.

By implication, the Court avers that the scope of scienter and the form of relief to which it applies remain subject to debate. Thus, whether the issue of requisite mental intent in private damage suits has been resolved is questionable. In declaring a scienter standard, the Court leaves its definition open by declining to pass on the sufficiency of recklessness. Furthermore, it creates a new issue in an area of the law that has been well settled, i.e., the necessary intent for SEC injunctive actions. In essence, the Court invites further litigation by casting doubts as to the form of behavior which will evoke liability under the Rule.

The purpose of this note is to examine the impact, and to suggest appropriate treatment, of the scienter standard enunciated by the *Hochfelder* Court on future suits brought by private parties seeking damages or SEC injunctions. To this end, a review of the *Hochfelder* decision is necessary, since an understanding of the basis for the Court's conclusion should lend insight into future treatment of these issues.

II. *Ernst & Ernst v. Hochfelder*

The cause of action in *Hochfelder* arose when plaintiffs, customers of First Securities Co. of Chicago, were induced by the president of First Securities to make investments in a supposed escrow account which ostensibly would yield a high rate of return. In reality, no such account had been established; the president had been converting the funds for his own personal use. In furtherance of this fraudulent scheme, the president introduced a rule which dictated that only he could open mail addressed to him, even if it arrived in his absence.

The defendant, Ernst & Ernst, a public accounting firm, was retained by First Securities to perform periodic audits of the firm's books and records and to prepare annual reports required by the SEC.[16] The plaintiffs charged defendant Ernst & Ernst with "aiding and abetting" First Securities' president's violation of Rule 10b-5 by negligently failing to perform proper audits. Plaintiffs contended that if Ernst & Ernst had utilized appropriate auditing procedures with due diligence, the existence of the mail rule would have been discovered and reported to the Midwest Exchange and the SEC as an irregular procedure that prevented defendant from making a thorough audit. Consequently, an SEC investigation would have revealed the fraudulent scheme.

The Supreme Court recognized that several circuit courts have held in substance that negligence alone is sufficient for civil liability under § 10(b) and Rule 10b-5.[17] Nevertheless, after examining the language of the statute itself to determine the requisite state of mind, the Court adopted a literal interpretation, concluding that: "The words 'manipulative or device' used in conjunction with 'device or contrivance' strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct."[18]

The Court justified this form of analysis by alluding to other sections of the Securities Act of 1933 and the Securities Exchange Act of 1934 which establish specific standards of conduct (including negligence) upon which liability may

16 17 C.F.R. § 240.17a-5 (1976).
17 96 S. Ct. at 1381 n.12.
18 *Id.* at 1383.

be predicated and pointing out that § 10(b) is conspicuously devoid of any standards for liability. From this the Court reasoned that since Congress provided standards of liability for particular sections of the 1933 and 1934 Acts, the absence of express standards must lead one to inquire into the actual language of the statute to ascertain legislative intent.[19]

Furthermore, the Court noted procedural restrictions which must be adhered to whenever civil remedies based on negligent conduct provided by the 1933 Securities Act are absent in § 10(b). Recognizing that procedural restrictions are more stringent when liability is premised on negligence rather than intent, the Court regarded this as a further basis for not extending liability under § 10(b) to actions brought for mere negligence.[20]

Though the Court asserts in a footnote that the opinion is restricted to private actions for damages,[21] the above reasoning is addressed to the language of § 10(b) without regard to the nature of relief sought. Thus, looking solely to the *Hochfelder* opinion, one could plausibly argue either for extending the scienter standard to SEC injunctive suits or confining it to private damage actions.

As the *Hochfelder* Court points out, an examination that goes beyond the statutory language itself to the legislative history of the 1934 Act sheds little light on the intended meaning of § 10(b).[22] The purpose and scope of § 10(b) were never directly addressed in committee hearings prior to the bill's enactment. The most relevant statement of the section's intended purpose was given by Thomas G. Corcoran, a spokesman for the drafters of the 1934 Act, who stated that "[§ 10(b)] says, 'Thou shalt not devise any other cunning devices' . . . . Of course subsection (c) is a catch-all clause to prevent manipulative devices."[23] The Court in *Hochfelder* asserted that this statement clearly negates the inference that negligence alone is one of the forms of conduct proscribed by this section. However, the use of "catch-all" strongly suggests that the section should be interpreted in a broad manner, and not restrictively.[24] Thus, the Court's conclusion that the legislative history of § 10(b) does not provide any "authority for construing 'manipulative devices' to include negligence"[25] must be tempered by the fact that there are no specific statements in the committee hearings and reports which explicitly exclude negligence.

A considered analysis of the statute must therefore entail an examination of a combination of factors: the language employed; public policy considerations; and analogy to common law liability, since the conduct specifically proscribed by the section has its roots in the common law. As will be seen from an examination of the treatment afforded § 10(b) by the various circuit courts, two categories of statutory construction have emerged based upon these factors. Prior to

19 *Id.* at 1388.
20 *Id.* at 1389.
21 *See* note 15 *supra.*
22 96 S. Ct. at 1385.
23 *Hearings on H.R. 7852 and H.R. 8720 before the House Comm. on Interstate and Foreign Commerce,* 73d Cong., 2d Sess., 115 (1934).
24 In SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 859-60 (2d Cir. 1968), the court relied on this statement to construe the "in connection with" requirement of § 10(b) in broad manner.
25 96 S. Ct. at 1386.

Hochfelder, the Seventh, Eighth, and Ninth Circuits had advocated a negligence standard for breaches of § 10(b). Upon ascertaining the respective duties of parties to a securities transaction, a negligent breach of that duty was deemed a violation of Rule 10b-5. The policy consideration underlying this position was simply a recognition that securities regulations were enacted for the purpose of avoiding fraud. Thus, the statutory proscriptions must be construed "not technically and restrictively, but flexibly to effectuate their remedial purposes."[26]

At the other end of the spectrum was the Second Circuit, whose literal reading of the words of § 10(b) closely comports with the standard enunciated in *Hochfelder*: the words "manipulative" or "device" only refer to intentional, and not negligent conduct.[27]

III. Scope of Scienter with Respect to § 10(b)

A. *Common Law Fraud and Scienter*

Specifically, Rule 10b-5 proscribes fraudulent practices. Hence, an understanding of its scope with respect to the inclusion of reckless conduct must begin with an examination of fraud at common law.

Traditionally, scienter has been required for a showing of fraud.[28] This scienter requirement for common law actions for fraud and deceit[29] has been a source of continuing controversy[30] since *Derry v. Peek.*[31] In that case, defendants issued a prospectus containing a statement which was unfounded. The House of Lords deemed that an action for deceit would not lie where mere negligence was shown. Rather, some element of intent had to be found.[32] This exclusion of negligent misrepresentation from deceit actions has been accepted by a majority of American courts but has been reversed by English courts which now impose a duty to make accurate representations.[33]

The scienter or intent standards of common law fraud are met where the misrepresentor: (a) is convinced of the falsity of his statement;[34] (b) knows that the statement is most likely false, although in his mind a slight possibility as to the

26 The dissent in *Hochfelder* took this position, citing SEC v. Capital Gains Research Bureau, 375 U.S. 180, 195 (1963).

27 *See* note 18 *supra.*

28 W. PROSSER, THE LAW OF TORTS, § 105, at 685-86 (4th ed. 1971) [hereinafter cited as PROSSER].

29 The development of a tort action for deceit has usually required the following: (1) false representation made by the defendant; (2) knowledge or belief on the part of the defendant that the representation is false or that a sufficient basis of information to make it does not exist; (3) an intention to induce plaintiff to act or refrain from acting; (4) justifiable reliance upon the representation; and (5) damage to the plaintiff. *See* PROSSER at 685-86. *See also,* F. HARPER & F. JAMES, THE LAW OF TORTS, § 7.1, at 528 (1956) [hereinafter cited as HARPER & JAMES]. The second element of the deceit action has commonly been equated with scienter. PROSSER at 700.

30 *See* Keeton, *Fraud: the Necessity for an Intent to Deceive,* 5 U.C.L.A.L. REV. 583 (1958).

31 14 App. Cas. 337 (1889).

32 For deceit to be actionable, there must be proof "that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false." *Id.* at 374.

33 PROSSER at 705.

34 *See, e.g.,* Seaboard Sur. Co. v. Permacrete Const. Corp., 221 F.2d 366 (3d Cir. 1955); McNabb v. Thomas, 190 F.2d 608 (D.C. Cir. 1951), *cert. denied,* 342 U.S. 859 (1951).

truth of his assertion exists;[35] or, (c) has no justifiable basis for believing the truth or falsity of the statement.[36] In all three situations, fraudulent intent is deemed to be present. This fraudulent intent exists not only when affirmative acts have taken place or representations have been given, but also when an omission or failure to disclose takes place and the relationship of the parties is such that a duty to make a full and accurate disclosure exists.

The latter two examples evidence conditions under which a statement is recklessly made. Though the declarant is not certain that his representation is false or misleading, there is no basis for asserting the truth of the statement. It should be noted that malice need not be shown for a court to find intent to deceive,[37] nor is a showing of actual knowledge of falsity a prerequisite to liability. Rather, the intent necessary to meet the scienter requirement is a showing of constructive knowledge; when the defendant's statement is made with such recklessness, knowledge of falsity will be attributed to him.[38] By contrast, when the misrepresentor is convinced of the truth of his assertion and this conviction is fully warranted by the circumstances, no liability for fraud will be found even though the facts ultimately prove to be false or misleading.[39]

A more gray area between misrepresentation, or failure to disclose, and justifiable belief in the truth of a statement exists when the declarant could honestly believe in the truth of his assertions, but realizes that the information upon which he is relying is not conclusive.[40] The majority rule at common law treats this situation as fraud if statements are made in ignorance of their falsity and a justifiable belief in their truthfulness is unwarranted. In such a case, an inference of intent is attributable to the misrepresentor even though actual intent to defraud or deceive is not present.[41]

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35 *See, e.g.,* Barrington v. Swanson, 249 F.2d 640 (8th Cir. 1958).

36 *See, e.g.,* Stein v. Treger, 182 F.2d 696 (D.C. Cir. 1950).

37 This is demonstrated in the RESTATEMENT OF TORTS, § 531, Comment b, Illustration 3, at 73 (1938): "A, believing that his brother B is an overcautious investor and wishing to induce him to buy securities which A believes will greatly increase in value, consciously overstates the facts in regard to the investment in question. A's good faith is shown by the fact that he himself has invested a large part of his own capital in the securities in question. The fact that A's motive is the desire to benefit his brother by inducing him to make a profitable investment does not prevent A from being liable to B."

38 PROSSER at 701.

39 Some courts and commentators contend that a misrepresentation gives rise to a rebuttable presumption that the requisite state of mind for fraudulent intent exists. For example, Dean Keeton, while not excusing intent, has proposed that considerations of fairness to the victim of the misrepresentation must give rise to a rebuttable presumption with the required state of mind being proved by circumstantial evidence. To meet the requirements of the presumption, one must merely allege: '(a) the unqualified assertion of fact by a person in a position to have reliable information and (b) the nonexistence of such fact or the falsity of the statement. Keeton *supra* note 30, at 584.

Were the thesis advanced by Keeton extended to 10b-5 actions, it would suffice to bring an action such as that brought by plaintiffs, Hochfelder et al., to the jury (assuming *arguendo* that other elements of 10b-5 liability are not at issue) for a determination of the necessary element of intent.

40 RESTATEMENT OF TORTS, § 526 (1938) posits that: "A misrepresentation in a business transaction is fraudulent if the maker (a) knows or believes the matter to be otherwise than as represented, or (b) knows that he has not the confidence in its existence or nonexistence asserted by his statement of his knowledge or belief, or (c) knows that he has not the basis for his knowledge or belief professed by his assertion."

41 In what is recognized as a landmark case in establishing the elements of common law liability for fraud, the court in Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441, *rev'g.*, 229 App. Div. 581, 243 N.Y.S. 179 (1931), held that public accountants certifying as fact, true to their knowledge that a balance sheet was in accordance with books of account,

It is evident that belief is the element which distinguishes states of mind which constitute recklessness from those which constitute mere negligence.[42] Liability for recklessness attaches where one has a genuine doubt as to the existence of a fact asserted, as well as when the declarant's conduct is so unreasonable or careless that an honest or bona fide belief is unjustified.[43] To avoid liability, this doubt or lack of knowledge must be disclosed.[44] Thus, two standards emerge upon which liability may be based: (1) the duty arising either at law or from the circumstances surrounding the situation to make a full and complete disclosure; and (2) the absence of a genuine belief in the truth of the representations. In the former, full and accurate disclosure is mandated by the duty. In the latter, there is no duty to speak. However, once a representation is initiated it must be made completely and with an honest belief in its truth.[45]

Case law has established that where a duty to disclose is required, reckless failure to determine, or to disregard, ascertainable facts constitutes liability for fraud. Similarly, reckless failure to make an accurate disclosure of all the facts within one's knowledge concerning an assertion made warrants liability.[46]

B. *Actionable Conduct under Rule 10b-5, Pre-*Hochfelder

Until *Hochfelder,* the circuit courts of appeal shouldered the task of interpreting Rule 10b-5 and fashioning the requisite elements for relief. There are obvious similarities in the rationales used by the different courts in construing Rule 10b-5. However, because of the complex nature of the statute, there are significant differences among these rationales. Each circuit's position is qualified by the weight it gives various factors, including the relationship between the parties, the character of the misrepresentor's conduct, and the type of relief sought.

Accordingly, the courts have failed to establish with uniformity the elements

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were not exonerated if the statement was false, because they believed it to be true. Judge Cardozo, writing for the court, held that an accountant could be liable for negligent misstatements only to the person who hired him or to a person who the accountant knew would rely on his statements. The court was careful to limit its holding solely to negligent misrepresentations adding: "Our holding does not emancipate accountants from the consequences of fraud. It does not relieve them if their audit has been so negligent as to justify a finding that they had no genuine belief in its adequacy, for this again is fraud. It does no more than say that, if less than this is proved . . . the ensuing liability for negligence is one that is bounded by the contract and is to be enforced between the parties by whom the contract has been made. *Id.* at 189, 174 N.E. 411.

See PROSSER at 701; HARPER & JAMES at 533; RESTATEMENT OF TORTS, § 526, Comment on Subsection (1a): "The fact that where the misrepresentation is one which a man of ordinary care and intelligence in the maker's situation would have recognized as false is not enough to impose liability upon the maker for a fraudulent misrepresentation under the rule (§ 526 Conditions Under Which Misrepresentation is Fraudulent), but it is evidence from which his lack of honest belief may be inferred."

42 PROSSER at 701.

43 *See, e.g.,* Anderson v. Tway, 143 F.2d 95 (6th Cir.), *cert. denied,* 324 U.S. 861 (1944).

44 Dean Keeton, in response to charges that finding fraud where there is a genuine belief is an imposition of strict liability, cites to HARPER & JAMES: "The situation actually falls within and is not an exception to the rule of *Derry v. Peek,* as one who is skeptical of the truth of his statements cannot be said to have an honest belief in the truth thereof." As such, he cogently concludes that the dispute over belief as an exculpatory element is simply "semantical debate." Keeton *supra* note 30, at 591.

45 *See* note 43 *supra* and accompanying text.

46 PROSSER at 701.

of a claim under Rule 10b-5.[47] The courts' application of scienter to the requirements of a claim under Rule 10b-5 has similarly been inconsistent and unclear. Moreover, the *Hochfelder* decision affords no guidance with respect to the scope of scienter.[48]

In considering proper standards of scienter, the courts agree that actual intent to injure is not necessary;[49] nor is innocent misrepresentation alone an acceptable standard for imposing liability under Rule 10b-5.[50] By contrast, considerable debate has centered on whether proof of negligence or recklessness, rather than actual knowledge, is necessary for a violation of the rule. The source of confusion in deriving a workable standard for scienter and 10b-5 is the myriad of situations in securities transactions which come under the purview of Rule 10b-5 private actions.[51]

Since predicting recovery under Rule 10b-5 entails consideration of many variables and innumerable interrelationships, scienter cannot be regarded as a rigid standard; rather, its limits must be imposed with reference to the circumstances of the particular case.

1. Negligence: *A fortiori* adaptation of recklessness

Prior to *Hochfelder,* the circuit courts were split as to whether negligence was a basis for a claim under 10b-5.[52] The Seventh, Eighth, and Ninth Circuits had adopted a negligence standard based upon requisite duty of care existing between the two parties to the transaction. In *Hochfelder v. Ernst & Ernst,*[53] the Seventh Circuit predicated liability upon this duty of care owed the plaintiff by the defendant. The court established a five point test based upon common law and statutory definitions of 10b-5 violations, for determining when a claim under the Act will arise: (1) the defendant has a duty of inquiry; (2) the plaintiff is a beneficiary of that duty; (3) the defendant breaches the duty; (4) concomitant with the breach of duty there is a breach of the duty of disclosure; and (5) a causal connection exists between a breach of duty of inquiry and disclosure, and the facilitation of the underlying fraud.[54]

47 It is beyond the scope of this note to explore other elements required for 10b-5 liability: materiality, reliance, privity, causation.

48 Prior to *Hochfelder,* the mental state element in Rule 10b-5 actions had not been directly addressed by the Supreme Court. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Superintendent of Ins. v. Bankers Life, 404 U.S. 6 (1971).

49 *See* JACOBS, *supra* note 1, § 63 n.23.

50 *Id.* at n.24.

51 2 A. BROMBERG, SECURITIES LAW: FRAUD, § 8.4, at 204.115 (1971). The author cogently points out that the source of confusion in deriving a workable standard for scienter with respect to 10b-5 actions is the myriad situations covered by the Rule when suit is brought. "A comprehensive scienter standard would have to . . . (include): (1) whether the violation is a misrepresentation, nondisclosure or some more complex scheme or manipulation; (2) Whether there is privity, a lesser relationship (such as aiding-abetting or conspiracy) or no privity at all (as in insider trading cases; . . . whether the transactions are direct or indirect; personal or impersonal; (3) Whether there is one plaintiff or thousands; (4) Whether there is some special relationship between the parties, such as fiduciary-beneficiary or broker-customer; (5) Whether the relief sought is damages, rescission, injunction or something else.

52 The *Hochfelder* Court recognized this split but asserted that few decisions endorsing a negligence standard have actually involved negligent conduct. 425 U.S. at 193-94 n.12.

53 503 F.2d 1100 (7th Cir. 1974).

54 *Id.* at 1104. *Accord* Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963).

Without delineating the elements which constitute liability the Eighth Circuit in *City National Bank v. Vanderboom*[55] applied a "reasonable investor" test which inquired whether a reasonable investor was entitled to rely upon a misrepresentation, considering the existing facts, or, in nondisclosure cases, whether he was entitled to full disclosure. The court held that negligent conduct was within the type of behavior 10b-5 based upon its remedial purpose, was intended to proscribe.

The issue of scienter's scope was avoided by the Ninth Circuit in *White v. Abrams*[56] where the court rejected common law fraud and all state of mind standards.[57] There, an inquiry into Rule 10b-5 liability was based solely on the defendant's duty. Again, the court admonished that securities legislation enacted for the purpose of avoiding fraud be construed flexibly to achieve this objective.[58]

The *Hochfelder* decision renders moot the debate as to the sufficiency of negligence in private actions for damages. Nevertheless, the rationale for the liberal construction given the terms of the statute by those courts advocating a negligence standard sheds light on how they can be expected to treat the scope of scienter with respect to Rule 10b-5 after *Hochfelder*. Since the Supreme Court in *Hochfelder* refused to confine the meaning of the term scienter to actual intent, to the exclusion of recklessness, the willingness of those courts which have extended the meaning of the statutory terms to include negligent conduct is a strong indication that such courts will include recklessness as a sufficient basis for Rule 10b-5 liability.

2. Pre-*Hochfelder* Inclusion of Recklessness in Rule 10b-5 Actions

Several circuit courts have expressly or impliedly accepted recklessness as a sufficient basis for a cause of action under § 10(b) and Rule 10b-5. In most instances, the court's application of a recklessness standard parallels the conditions under which common law fraud obtains: the declarant lacks a genuine belief in the statement's truth, or the representation is made recklessly and a duty exists to make full and accurate disclosure.[59]

Since nuance abounds and clearly defined terms are lacking in this area, the pronouncement of a recklessness standard is often qualified by the particular facts of a principal case. In *Woodward v. Metro Bank*,[60] a Fifth Circuit case, the cosigner of a note, who had pledged securities, alleged that defendant bank had aided and abetted the loan recipient in perpetrating a fraud upon him. The court required scienter which entailed fraud, but did not require actual intent.

55 422 F.2d 221 (8th Cir. 1970).

56 495 F.2d 724 (9th Cir. 1974). "The standard we have set forth . . . does not impose absolute liability for misrepresentations regardless of the person's knowledge of falsity. It rejects the use of Latin terms which obfuscate the Rule and confuse the result. It rejects the idea that conduct in complex Rule 10b-5 cases may be neatly compartmentalized into traditional concepts which have often resulted in jamming facts together in an effort to fit the concept. While rejecting scienter and state of mind concepts as the standard itself, it requires the court to consider state of mind." *Id.* at 736.

57 *Id.* at 734. *See* Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter,* 45 N.Y.U.L. REV. 1206 (1970).

58 495 F.2d at 724.

59 *See* notes 42-43 *supra* and accompanying text.

60 522 F.2d 84 (5th Cir. 1975).

Rather, an element of scienter was required, "at least to the extent that something more than ordinary negligence [was] required for 10b-5 liability."[61] From their treatment of the scienter requirement when aiding and abetting is alleged, it is apparent that the *Woodward* court adopts a recklessness standard. The court held that where no duty of disclosure exists, a higher standard of scienter, consisting of some form of actual knowledge or "high conscious intent," was required.[62] But, where a special duty of disclosure exists, the declarant is liable upon a lesser showing of knowledge.

This distinction is relevant in applying any liability standard to determine whether a duty to disclose has been breached. Nevertheless, this determination must depend on the relationship between the parties. Thus, when one has a duty to disclose a reckless misstatement or a failure to disclose material facts, even facts not within one's actual knowledge, are sufficient for a 10b-5 action in the Fifth Circuit. The result would be the same whether defendant was directly involved in the transaction or charged with merely aiding and abetting another's fraud.

Other courts have implied that a reckless breach of the duty to disclose, as in *Woodward,* must be present before a claim under Rule 10b-5 arises. In *Clegg v. Conk,*[63] where plaintiffs were allegedly induced to make investments based upon defendant's misrepresentations, the Tenth Circuit clearly rejected a negligence standard. Citing *Financial Industrial Fund v. McDonnell Douglas Corp.,*[64] the court recognized the necessity for a scienter standard in Rule 10b-5, but noted that a duty to disclose requires that a declarant exercise due care in making statements and, where information is available, that the declarant exercise due diligence in ascertaining the material facts. The court emphasized that the Rule must be interpreted flexibly and in a manner compatible with its remedial purpose. The Tenth Circuit thus adopts a literal interpretation of, and maintains an appreciation for, the purpose of the statute as advocated by those supporting a liberal construction. As such, the *Clegg* court is receptive to affording relief to the extent of the terms' contemporary connotations. This approach permits the inclusion of recklessness without sacrificing the plain meaning of the terms as required by *Hochfelder.*

Several circuit courts have sanctioned recklessness as a sufficient basis for a 10b-5 claim, but have confined its application to cases where the defendant has actual knowledge of material information. This approach ignores situations in which a party to a securities transaction has recklessly failed to ascertain facts available when a duty to do so exists.[65] Decisions of the Second Circuit, which has dealt with the scienter element in 10b-5 actions more extensively (and stringently) than the other circuits, best illustrate this position.

Beginning with *Fischman v. Raytheon Manufacturing Co.,*[66] in which purchasers in a class action alleged defendant corporation's prospectus contained fraudulent misrepresentations and omissions, the Second Circuit required an

61 *Id.* at 93.
62 *Id.* at 97.
63 507 F.2d 1351, 1359 (10th Cir. 1974).
64 474 F.2d 514 (10th Cir.), *cert. denied,* 414 U.S. 874 (1973).
65 *See* note 46 *supra* and accompanying text.
66 188 F.2d 442 (2d Cir. 1951).

allegation and proof of fraud. The court shed some light on the scope of scienter in *Shemtab v. Shearson Hammill & Co.*[67] where defendant brokerage firm allegedly failed to sell plaintiff's account as represented, by declaring that a claim "cannot be bootstrapped into an alleged violation of Rule 10b-5 in the absence of allegation of facts amounting to scienter, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud. It is insufficient to allege mere negligence."[68] While mention was made of "reckless disregard," the claim alleged actual knowledge, rather than constructive knowledge, arising from the defendant's recklessness.

The court adhered to its previous position in *Lanza v. Drexel & Co.*[69] where it refused to hold a director liable for failure to disclose material adverse information absent "substantial participation in the concealment or knowledge of it."[70] The facts in this case can be analogized to the situation in *Hochfelder,* since the liability of the defendants with respect to the plaintiffs was premised on an affirmative duty to perform contracted services and to convey material information within their knowledge. As in *Hochfelder,* the basis of the charge was aiding and abetting the defrauder. The court reaffirmed its holding in *Shemtab*: scienter requires actual knowledge, or omissions amounting to a willful, deliberate, or reckless disregard for truth that is the equivalent of knowledge. In a footnote, the court gave a definition of this language:

> In determining what constitutes "willful or reckless disregard for the truth" the inquiry normally will be to determine whether the defendants knew the material facts misstated or omitted, or failed or refused, *after being put on notice of a possible material failure of disclosure,* to apprise themselves of the facts where they could have done without any extraordinary effort. *Chris Craft Industries, Inc. v. Piper Aircraft Corp.,* 480 F.2d 341, 363-364, 396-399 (2d Cir. 1973). The answer to the inquiry will of course depend upon the circumstances of the particular case, including the nature and duties of the corporate positions held by the defendants.[71]

Obviously, from the definitions given by the court, notice is significant when the existence of recklessness is asserted. In the absence of notice, a question arises as to the extent to which the defendant's duty requires him to ascertain material facts before recklessness will be found. The definition advanced by the court does not refer to the situation in which a defendant, though not having notice of a material misstatement or omission, nevertheless has failed to fulfill his duties so that the breach constitutes reckless disregard or constructive knowledge.

Following *Holchfelder,* several district courts within the Second Circuit have considered the Supreme Court's definition of scienter. In response to plaintiff's allegation that defendants negligently managed her portfolio, the court stated in *Carroll v. Bear, Stearns & Co.,*[72] that "Under the law in this Circuit—and certainly after the *Ernst* decision—such allegations, in the absence of an allegation of facts amounting to scienter, intent to defraud or intentional misconduct,

67 448 F.2d 442 (2d Cir. 1971).
68 *Id.* at 445.
69 479 F.2d 1277 (2d Cir. 1973).
70 *Id.* at 1302.
71 *Id.* at 1306 n.98 (emphasis added).
72 416 F. Supp. 998 (S.D.N.Y. 1976).

are insufficient to state a claim under Rule 10b-5."[73] The court made note that the Supreme Court left open the possibility that reckless behavior might constitute a violation of the Rule, stating that "even were we to assume arguendo, that recklessness is a sufficient predicate for 10b-5 liability, plaintiff's allegation would not meet the court's scienter standard."[74] The court thus implies that the issue of whether recklessness is an element of scienter remains unresolved.

This reasoning was followed by the same court in *Siclaro v. Rio de Oro Mining Co.*[75] In absolving a newspaper from liability for publication of factually incorrect information the court declared:

> Absent an allegation of facts which would indicate that the defendant had some reason to doubt the truth of the statements contained in the article, 10b-5 liability does not exist.[76]

Again, the court makes reference to recklessness, stating that "even assuming . . . that reckless disregard for the truth can, under certain circumstances, satisfy the scienter requirement, . . . the allegations do not give rise to such recklessness."[77] The use of "even assuming" reaffirms the lack of resolution within the Second Circuit for including recklessness as a 10b-5 basis of liability.

On the basis of the pre-*Hochfelder* cases decided in the Second Circuit, it is clear that recklessness, constituting a basis for a 10b-5 action, exists when the defendant has actual knowledge of material facts and fails to make a full and accurate disclosure. Though actual intent may be lacking, implied intent can be found. This comports with common law principles of fraud, as certainly no genuine belief in the truth of the disclosure could exist on the part of the declarant where material facts are within his knowledge. Nor could an omission be justified where there was a duty to disclose material information. However, there is no authority in the cases for finding 10b-5 liability where a party's harm arises from reckless failure to ascertain material facts in the absence of actual knowledge or notice that such facts exist.

The post-*Hochfelder* decisions by district courts within the Second Circuit do not shed any further light on this issue. These holdings are examples of the circuit's nebulous posture with respect to the scope of scienter, and do not indicate clearly a position with regard to an acceptance of recklessness as part of the scienter requirement.

C. *Future Scope of Scienter in Rule 10b-5 Actions*

As demonstrated above, the common law provides recovery for actions in fraud or deceit when recklessness is proved. Recognizing the Supreme Court's holding that the language of the statute itself conveys an intention to proscribe fraudulent practices in securities transactions, it logically follows that common law elements of fraud should be incorporated into the elements constituting

73 *Id.* at 1000.
74 *Id.*
75 [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,672 (S.D.N.Y. 1976).
76 *Id.* at 90,312.
77 *Id.*

liability under § 10(b) and Rule 10b-5. Thus, the Supreme Court's limiting of 10b-5 liability to a charge alleging scienter should not preclude an action based on recklessness, whether that recklessness precipitates failure to make a full and accurate disclosure or to ascertain material facts in the absence of actual knowledge.

Support for this can be found in *Alexander v. McLean,*[78] the opinion which addresses most extensively the issue of recklessness' inclusion within the purview of the 10b-5 scienter requirement. There, an accountant misrepresented that a corporation's accounts receivable were sales when they were actually consignments. This induced plaintiff to purchase the corporation's securities. The court found that this amounted to recklessness sufficient to establish liability under Rule 10b-5. It reasoned that the inclusion of recklessness in common law deceit, together with the legislative history and intended purpose of 10b-5, justified a finding of liability upon a showing of recklessness.[79] The defendant accountant not only had actual knowledge of material facts which he failed to disclose, but was reckless in failing to inquire into internal inconsistencies where available facts demonstrated a need for a satisfactory explanation from management. Thus, the defendant was held to a recklessness standard not only in making full and accurate disclosure of facts within his knowledge but also in ascertaining facts at hand.[80] This holding is less susceptible to an attack alleging an insufficient mental state, because it incorporates the principles of common law fraud into the area of securities regulations.

The Court in *Hochfelder* emphasized the intended meaning of the statutory language of Rule 10b-5. Because the Court construed the statute as proscribing fraudulent conduct,[81] common law elements of fraud are appropriate guidelines for ascertaining 10b-5 liability. An incorporation of common law fraud which requires absence of genuine belief of the truth, and a duty to make full and accurate disclosure, would help eliminate many of the interpretation problems which exist. With the exception of the Second Circuit (and then only with respect to reckless failure to determine the facts where a duty exists), prior holdings within the various circuits find that recklessness is a sufficient ground for establishing 10b-5 liability.

Obviously, additional factors (e.g., privity, type of remedy sought, whether an affirmative statement or omission is the source of controversy, and the parties involved) must be considered when liability is determined. However, these elements go to the degree of conduct which must be reached before liability will obtain—not whether recklessness itself is a sufficient condition for a 10b-5 cause of action. Recklessness cannot be considered a static concept. Rather, it must be perceived as a standard which will be determined by the attendant circumstances of the particular case.

78 420 F. Supp. 1057 (D.C. Del. 1976).
79 *Id.* at 1084.
80 *Id.* at 1086.
81 *See* note 18 *supra* and accompanying text.

IV. Extension of Scienter Standard to Injunctive Actions

The *Hochfelder* Court declined to consider whether a scienter standard would extend to actions under § 10(b) and Rule 10b-5 for injunctive relief.[82] In considering the impact of the Court's position upon future suits seeking injunctive relief based upon Rule 10b-5, the purpose of, and requisite elements for, such relief should also be examined from a perspective of legislative intent, prior case law, and public policy.

A. *Purpose of Injunctive Relief under Rule 10b-5*

Injunction actions are brought to halt current, foreseeable, or, in some instances, past violations of securities regulations by issuers, broker-dealers or investment advisors, or any other person connected with a securities transaction.[83] Typically, an injunctive decree is a court order commanding a defendant to refrain from committing acts that violate the law, or to do certain acts necessary to achieve compliance. Enforcement of the decree is usually achieved through the traditional contempt powers of the federal district courts. If a defendant fails to comply, he may be prosecuted for civil or criminal contempt.[84]

B. *Source of Authority to Bring Injunction Actions*

A right to injunctive relief has been implied for private parties by the courts under § 10(b). This remedy, however, is rarely invoked.[85] Since an aggrieved party's harm is usually "after-the-fact," damages or rescission provide more compensatory relief. Recognizing that "an honest and true securities market is dependent upon the effective enforcement of the legislative mandate in these acts,"[86] and that improprieties in the securities market place have a pervasive adverse impact, Congress granted the SEC in the Securities Exchange Act of 1934 the express right to seek injunctive relief. Thus, § 21(d) authorizes SEC injunctive actions for violations of the Act, and the rules promulgated thereunder, by declaring:

> Whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter, the rules or regulations thereunder, . . . it may in its discretion bring an action . . . to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted. . . .[87]

82 *See* note 15 *supra* and accompanying text.

83 *See, e.g.*, SEC v. Culpepper, 270 F.2d 241, 250 (2d Cir. 1959); SEC v. Dott, 302 F. Supp. 169 (S.D.N.Y. 1969); SEC v. Franklin Atlas Corp., 171 F. Supp. 711, 718 (S.D.N.Y. 1959); 3 Loss, SECURITIES REGULATION 1977 (1961).

84 *See,* Matthews, *Criminal Prosecution under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases,* 39 GEO. WASH. L. REV. 901 (1971); A. Matthews, *SEC Civil Injunctive Actions,* 5 REV. SEC. REG. No. 4 (1972), in A. MATTHEWS, B. FINKELSTEIN, & H. MILSTEIN, ENFORCEMENT AND LITIGATION UNDER THE FEDERAL SECURITIES LAWS (1973).

85 *See, e.g.,* Ruckle v. Roto Am. Corp., 339 F.2d 24 (2d Cir. 1973).

86 S. REP. No. 1455, 73d Cong., 2d Sess., 393 (1934).

87 Securities Exchange Act of 1934, 15 U.S.C. § 78u(d) (1970).

Inherent in the SEC's authority to seek injunctions is the resort to equity. Once equity jurisdiction has been invoked, all traditional equitable powers may be applied in the form of ancillary relief.[88] Such additional or alternative remedies often include: (1) the appointment of a receiver;[89] (2) restitution or disgorgement of profits;[90] and, (3) rescission.[91] Hence, the issue of the extent to which a scienter standard will be applied, as raised by the *Hochfelder* decision, necessarily affects these forms of relief. However, it is beyond the scope of this note to examine the impact of the decision on these equitable forms of relief.

C. *Traditional Requisites for Obtaining Injunctive Relief*

Section 21(d) requires that, before an injunction will issue, the SEC must demonstrate by a "proper showing" that a person "is engaged or about to engage in acts or practices constituting a violation of any provision of this chapter, [and] the rules . . . thereunder."[92] Relying solely upon this section, an injunction will be granted against a person "engaged or about to engage" in a proscribed act whether the act is performed willingly, negligently or innocently. However, since § 21(d) does not prescribe a culpability standard, application of the injunctive powers which it authorizes to an alleged 10b-5 violation will require the Commission to demonstrate that such acts constitute a violation of § 10(b) and Rule 10b-5.

The elements of a "proper showing" vary according to the type of injunctive relief being sought. The SEC may seek one of three forms of injunctions; (a) a temporary restraining order (TRO); (b) a preliminary injunction; or (c) a final or permanent injunction. Rule 65(b) of the Federal Rules of Civil Procedure governs TROs and requires that "immediate and irreparable injury" will accompany further alleged statutory violations.[93] For a preliminary or permanent injunction, the Commission need not meet Rule 65(b), but rather must show that past conduct and circumstances show a threat or reasonable likelihood of future violations.[94] This is a somewhat more relaxed standard than that required of a private litigant seeking injunctive relief. The Supreme Court has repeatedly held that the equitable powers of a court are broader and more flexible when a public agency sues than when redress is sought by a private party, because the public interest is involved.[95]

It is well established that acts or omissions resulting from a lack of due

88 "There is little doubt that § 27 of the Securities Exchange Act confers general equity power upon the district courts." SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1307-08.

89 *See, e.g.*, SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972); SEC v. 5th Ave. Coach Lines, 289 F. Supp. 3 (S.D.N.Y. 1968).

90 *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 796 (1969).

91 *See, e.g.*, SEC v. Bangor Punta Corp., 480 F.2d 341 (2d Cir. 1973).

92 *See* note 88 *supra* and accompanying text.

93 FED. R. Civ. P. 65(b).

94 *See, e.g.*, United States v. W.T. Grant, 345 U.S. 629, 633 (1953); 401 F.2d at 1100; 270 F.2d 249.

95 *See, e.g.*, Mitchell v. Robert DeMario Jewelry, Inc., 361 U.S. 288, 291-92 (1960); Hecht Co. v. Bowles, 321 U.S. 331 (1944); H. Pitt & J. Markham, *SEC Injunctive Actions*, 6 REV. SEC. REG. No. 5 (1973) in DEFENDING SEC ENFORCEMENT ACTIONS (1973).

diligence, or negligence, can be enjoined under Rule 10b-5.[96] Thus, proof of intent to mislead or scienter is unnecessary. However, proof that past conduct was wilfully fraudulent enhances the likelihood of finding "a reasonable expectation of continued violations. . . ."[97]

The decision most often relied upon in support of this position is the Supreme Court holding in *SEC v. Capital Gains Research Bureau.*[98] This case refutes the notion that scienter applies regardless of the nature of relief being sought. Although the case concerned alleged violations of the Investment Advisers Act of 1940,[99] the principles espoused by the Court are equally applicable to § 10(b) of the 1934 Act since the Court explicitly made reference to the common purpose of the two acts.[100]

In establishing that intent to injure was not a necessary element in an action to enjoin conduct which operates "as a fraud or deceit" under the Act, the Court recognized that, at common law, intent is a necessary element for recovery of damages. The Court was quick to point out that the relief sought in the case, a preliminary injunction, was prospective and equitable and that at common law a party seeking equitable relief based on another's fraud was not required to prove intent to defraud.[101] In support of this the Court pointed out:

> The content of common law fraud has not remained static. It has varied, for example with the nature of the relief sought, the relationship between the parties, and the merchandise in issue. It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages. . . . We cannot assume that Congress in enacting legislation to prevent fraudulent practices by investment advisers, was unaware of these developments in the common law of fraud. Thus, even if . . . Congress had intended, in effect, to codify the common law of fraud . . . it would be logical to conclude that Congress codified the common law "remedially" as the courts had adapted it to the prevention of fraudulent securities transactions by fiduciaries, not technically as it has traditionally been applied in damage suits. . . .[102]

Similar to the discussion concerning the inclusion of recklessness in the definition of scienter, common law principles with respect to fraud provide a basis for distinguishing between the form of relief sought and the necessary degree of culpability.

This rationale has been followed by several circuit courts with respect to injunction actions under Rule 10b-5. In *SEC v. Texas Gulf Sulphur,*[103] Judge Friendly cited the *Capital Gains* decision as the basis for issuing an injunction against parties who had negligently prepared a press release.[104] More recently,

96 *See, e.g.,* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963); SEC v. Texas Gulf Sulphur, *on remand,* 312 F. Supp. 77, 88 (S.D.N.Y. 1970); Bromberg, *supra* note 8, at § 8.4; Note, *Scienter and Rule 10b-5,* 69 COLUM. L. REV. 1057, 1076 (1969).
97 458 F.2d at 1100.
98 375 U.S. 180 (1963).
99 15 U.S.C. §§ 80b-1 to 80b-20 (1970).
100 375 U.S. at 186.
101 *Id.* at 193.
102 *Id.* at 195.
103 401 F.2d 833.
104 *Id.* at 868.

the Second Circuit stated that the negligence standard is "generally applicable to SEC injunctive actions. . . ."[105] The Seventh and Tenth Circuits have followed this lead.[106] Only the Sixth Circuit requires a higher standard than negligence—"wilfull or reckless disregard for the truth."[107] Nevertheless, it has recognized that *Capital Gains* may require a lower standard for SEC injunctive actions than is required in a private suit for damages.

D. *Confining the* Hochfelder *Decision to Private Actions for Damages*

In spite of prior case law, there are several arguments for extending the application of the scienter standard articulated in *Hochfelder* beyond private suits for damages. The *Hochfelder* Court specifically stated that the language and history of § 10(b) is dispositive of its interpretation.[108] At least one post-*Hochfelder* case, *SEC v. Bausch & Lamb,*[109] interpreted this statement as advocating the application of a scienter standard to SEC injunctive suits. The court refused the SEC's request for an injunction against a corporate officer charged with "tipping" nonpublic earnings figures. Referring to the Supreme Court's holding in *Hochfelder* that the language and history of § 10(b) is dispositive, the court reasoned that this must be so for SEC injunctive suits, since such suits are creatures of the statute rather than implied rights of action.[110]

A second argument is that the Court's refusal to expressly set out rules concerning the necessary standard of intent and the remedy sought evidences an intent to apply a scienter standard to all 10b-5 actions without regard to the nature of the relief being sought. However, prior case law and the traditional policy considerations associated with equitable forms of relief, along with what legislative history exists, clearly mandate a contrary conclusion.

The rationale of the Court in *Capital Gains* is still persuasive evidence of the Court's intent to distinguish the necessary elements for injunctive relief from those required in an action for damages. When equity is invoked at common law, it is well established that the requirements for recovery are diminished. This distinction is firmly entrenched in securities litigation and was recently reaffirmed by the First Circuit in *SEC v. World Radio Mission,*[111] the only circuit court case to pass on the issue of scienter and SEC injunction actions in light of *Hochfelder.* In affirming a lower court injunction against a religious organization for failing to properly report interest bearing notes, the court pointed out that "An injunction is designed to protect the public against conduct, not to punish a state of mind."[112] Thus, the court, while recognizing the necessity of scienter in a private action for damages under Rule 10b-5, declared that intent is irrelevant in an SEC action for an injunction.[113]

105 SEC v. Management Dynamics, 515 F.2d 801, 811 (2d Cir. 1975).
106 *See, e.g.,* SEC v. Dolnick, 501 F.2d 1279 (7th Cir. 1974); SEC v. Pearson, 426 F.2d 1339 (10th Cir. 1970).
107 SEC v. Coffey, 493 F.2d 1304, 1314 (6th Cir. 1974), *cert. denied,* 420 U.S. 908 (1975).
108 96 S. Ct. at 1391 n.33.
109 420 F. Supp. 1226 (S.D.N.Y. 1976).
110 *Id.* at 1240.
111 544 F.2d 535 (1st Cir. 1976).
112 *Id.* at 541.
113 *Id.* at 540.

In addition to cases directly addressed to the issue which support a negligence standard for injunction actions, or at least a standard less stringent than scienter, *Hochfelder* is one in a series of Supreme Court decisions which limit the remedies of private plaintiffs under the federal securities laws. These cases do not limit, however, the remedies of the Commission.[114] This trend is consistent with that of the Court enunciated in *Hecht v. Bowles*:[115] the equitable powers of the courts should be applied more broadly and flexibly when a public agency sues because of the public interest involved.

An additional basis for refusing to expand the application of the scienter standard announced in actions for injunctive relief can be found in the legislative history of the 1933 and 1934 Acts. Section 17(a) of the 1933 Act was the precursor to § 10(b) of the 1934 Act; the principal difference between the two is that the 1933 Act afforded relief only to sellers of securities. Prior to passage of the 1933 Act, the bill was amended so that the requirement of wilfulness and intent to defraud to obtain an injunction was deleted.[116] The Seventh Circuit relied upon this in refusing to require an allegation and proof of scienter in a Commission injunctive action.[117] Considering the lack of known legislative intent concerning § 10(b), this incident is doubly significant.

Finally, the policy that prompted the Supreme Court to relax the evidentiary burdens for injunctive actions brought by the SEC,[118] *i.e.* the need to protect the public's interest, should be applied to the necessary mental state element. Where violations of the Rule can affect vast numbers of investors, the potential harm outweighs the need for a stringent intent standard. Furthermore, not only must the nature of the interest to be protected be considered for purposes of policy, but also the type of harm to be prevented. Injunctive relief invoked in equity is prospective in nature and recognizes the imminent danger to the petitioning party, whether that be a private plaintiff or the SEC, should subsequent violations occur. Thus, provided the burden of proof requirements are met, less stringent intent standards should suffice.

V. Conclusion

The 1934 Securities Exchange Act was enacted to avoid the problems which arise from inadequate regulation of securities transactions. Though the history of § 10(b) fails to specifically state the drafters' intent, the description of the provision as a "catch-all,"[119] and the purpose of the act itself, mandate a broad and remedial construction of the terms of the statute. Such a treatment of securities legislation designed to prevent abuses was expressly sanctioned by the Supreme

114 Rondeau v. Mosinee Paper Corp., 422 U.S. 49, 61 (1975) (Plaintiff seeking injunctive relief based upon § 13(d) of the 1934 Act, 15 U.S.C. § 78m(d) (1970), must establish irreparable harm according to traditional prerequisites of equitable relief.); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730-31 (1975) (Plaintiffs must be actual sellers or purchasers of securities in order to bring a private action for damages under Rule 10b-5); *See* Berner & Franklin, *Scienter and SEC Rule 10b-5 Injunctive Actions: A Reappraisal in Light of Hochfelder*, 51 N.Y.U.L. REV. 769, 779 (1976).

115 321 U.S. 321, 331 (1944).

116 H.R. REP. No. 5480, 73d Cong., 1st Sess. (1933).

117 SEC v. VanHorn, 371 F.2d 181, 184-86 (7th Cir. 1966).

118 *See*, 321 U.S. at 331.

119 *See* text accompanying note 23 *supra*.

Court in *Capital Gains*.[120] Moreover, to interpret the section in a restrictive and technical manner would ignore these purposes and fail to recognize their common law foundations.

The *Hochfelder* decision removes considerable speculation as to the necessary element of intent for private damage actions under Rule 10b-5. However, the case should not be interpreted further as modifying accepted elements of fraud that have been incorporated into § 10(b) in a manner that strains both common law principles and the 1934 Act's intended purpose. Recklessness clearly falls within the construction given common law fraud today. Therefore, when considering the abuses which the Act expressly proscribes and their common law bases, recklessness is inherently included in the language of § 10(b) as the *Alexander*[121] court concluded.

Similarly, the distinction between requisite elements for equitable relief as opposed to damage actions is grounded in the common law of fraud. This distinction has been widely recognized and incorporated in securities legislation designed to prevent fraudulent conduct, and is motivated by the policy consideration that suits in equity prospectively vindicate important public and private rights. To disregard this distinction in the absence of an express denial by that Court which has affirmed its existence in the law would be a gross deviation from the opinion itself, case law precedent, and common law precepts.

Hochfelder should be interpreted as defining the necessary intent for a private action for damages under Rule 10b-5 consistent with the common law meaning to be given the statutory terms. As such, the Court's intent to establish a scienter standard is achieved without sacrificing the Rule's "remedial purpose."

Of course, the ultimate resolution of these issues is for the courts. Based upon pre-*Hochfelder* standards of intent for Rule 10b-5 private damage actions, it is fairly certain that recklessness will be included within the scope of scienter. All of the federal circuits have either expressly advocated a negligence standard, and thus sanctioned recklessness, or specifically provided that recklessness would suffice. Only the Second Circuit has qualified its endorsement of a recklessness standard by including it within scienter's scope where actual knowledge is present. That court, however, has not addressed the situation in which a party's harm arises from reckless failure to ascertain material facts in the absence of actual knowledge.

Interpretation of the *Hochfelder* decision as signaling a retreat from traditional standards of liability when equity is invoked is unlikely. Though the Court raised the issue of extending the application of a scienter standard to SEC injunctive actions by declining to pass on the question, distinguishing necessary standards of intent based on the nature of relief sought is firmly entrenched in the law. As evidenced by the holding in *World Radio Mission*, the mere fact that the Court has required a scienter standard for private damage actions upon a determination that the statute is intended to proscribe fraudulent conduct does not suggest that the Court is inclined to waive this fundamental distinction.

D. Craig Martin

120 *See* text accompanying note 102 *supra*.
121 *See* text accompanying note 79 *supra*.